

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B01

PLR-145139-07

Date: April 3, 2008

### Legend

X =

A =

Trust =

State =

City =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

#a =

#b =

#c =

#d =

\$k =

\$l =

\$m =

\$n =

u% =

Dear :

This letter responds to your letter dated September 18, 2007, submitted on behalf of X, requesting relief under § 1362(f).

### Facts

According to the information submitted, X was incorporated under the law of State on Date 1. A, X's sole shareholder, elected for X to be treated as an S corporation beginning on Date 2.

X's business consists of holding and managing commercial real property. On or before Date 2, one parcel of real property that was owned by X was acquired by City in accordance with an eminent domain proceeding. On or before Date 2, X purchased Treasury Bonds with the proceeds that X received in the eminent domain proceeding.

Due to the income from the Treasury Bonds, X received passive investment income (within the meaning of § 1362(d)(3)) in excess of 25% of its gross receipts during the consecutive taxable years of Year 1, Year 2, and Year 3. Furthermore, X had accumulated earnings and profits remaining in each of these three years. Because of the excess net passive income, X's S election terminated on Date 3. X has not had passive investment income in excess of 25% of its gross receipts since Year 4, and sold the Treasury Bonds in Year 5.

A died on Date 4. Each of A's #a children ("Shareholders") inherited #b out of #c shares of the stock of X. After receiving consent from the board of directors of X and after entering into a stock redemption agreement with the Shareholders, on Date 5 X redeemed #d shares (u% of each Shareholder's holdings in X) from each of the Shareholders in return for \$k. At the time of the redemption, X had \$l of accumulated earnings and profits.

#### Rulings Requested

X is requesting two rulings:

1. The termination of X's S corporation election as of Date 3 was inadvertent and is waived.
2. The redemption of u% of X stock on Date 5 resulted in a u% reduction of X's C corporation accumulated earnings and profits.

#### Representations

X represents that the termination of its S election was inadvertent and not the result of tax avoidance or retroactive tax planning. X, along with A and its current Shareholders, have consistently treated X as an S corporation and agree to make any adjustments consistent with the treatment of X as an S corporation that may be required by the Secretary.

In connection with the redemption, X has made the following representations:

1. The amount paid in redemption of the stock did not exceed the sum of the federal and death taxes (including interest collected as part of such taxes) imposed because of the death of A plus the amount of funeral and administration expenses allowed as deductions to A's estate ("Estate") under § 2053. All death taxes and funeral and administrative expenses were paid by the trustee of Trust.
2. The federal and State taxes imposed as a result of A's death were \$m while the total amount of the redemption proceeds were \$k.

3. The fair market value of the stock included in Decedent's gross estate for federal estate tax purposes exceeded 35 percent of the gross estate over the amounts allowable as deductions under §§ 2053 and 2054.
4. In the redemption, each of the Shareholders received cash which was approximately equal to the fair market value of the stock in X surrendered in exchange therefor. The interests of the Shareholders were directly reduced by the redemption used to pay funeral expenses, administration expenses and death taxes.
5. X and the Shareholders each paid their own expenses incurred in the redemption transaction.
6. No Shareholder is, or was, obligated to purchase any of the stock that was redeemed.
7. The Shareholders did not transfer any property to X other than stock in Company.
8. The redemption was the first redemption of any stock included in Estate.
9. There was no plan to issue additional stock and there were no outstanding warrants or options to purchase stock in X, nor were there any outstanding debentures or obligations that were convertible into stock in Company at the time of the redemption. There was no plan or intention at the time of the redemption to issue any options, warrants, debentures, or other obligations that would be convertible into stock, or which would be considered to be X stock.
10. There were no declared but unpaid dividends, or funds set apart for dividends, on any X stock at the time of the redemption.
11. The redemption was completed Date 5, approximately one year after the death of Decedent, so that it occurred in the period subsequent to Decedent's death that is specified in § 303(b)(1).

### Law

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year .

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of three consecutive taxable years, and has gross receipts for each of the taxable years more than 25% of which are passive investment income. The termination is effective on and after the first date of the first tax year beginning after the third consecutive tax year referred to in § 1362(d)(3)(A)(i). Section 1362(d)(3)(A)(ii).

Except as otherwise provided in § 1362(d)(3)(C), § 1362(d)(3)(C)(i) provides that the term “passive investment income” means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents, or (B) was terminated under paragraph (2) or (3) of § 1362(d), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) provides that the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner. In the case of a transfer of stock to an ineligible shareholder that causes an inadvertent termination under § 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the

corporation. Moreover, the Commissioner may require protective adjustments that prevent any loss of revenue due to a transfer of stock to an ineligible shareholder (e.g., a transfer to a nonresident alien).

Section 1375 imposes a tax on the income of an S corporation that has accumulated earnings and profits at the close of a taxable year, and that has gross receipts more than 25% of which are passive investment income (within the meaning of § 1362(d)(3)).

A distribution of property to a shareholder by a corporation in redemption of part or all of the stock of such corporation which (for Federal estate tax purposes) is included in determining the gross estate of a decedent, to the extent that the amount of such distribution does not exceed the sum of (1) the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent's death, and (2) the amount of funeral and administration expenses allowable as deductions to the estate under § 2053 (or under § 2106 in the case of the estate of a decedent nonresident, not a citizen of the United States), shall be treated as a distribution in full payment in exchange for the stock so redeemed. Section 303(a).

Section 303(a) applies only to amounts distributed after the death of the decedent and (A) within the period of limitations provided in § 6501(a) for the assessment of the Federal estate tax (determined without the application of any provision other than § 6501(a)), or within 90 days after the expiration of such period, (B) if a petition for redetermination of a deficiency in such estate tax has been filed with the Tax Court within the time prescribed in § 6213, at any time before the expiration of 60 days after the decision of the Tax Court becomes final, or (C) if an election has been made under § 6166 and if the time prescribed by this subparagraph expires at a later date than the time prescribed by subparagraph (B) of this paragraph, within the time determined under § 6166 for the payment of the installments. Section 303(b)(1).

Section 303(a) applies to a distribution by a corporation only if the value (for Federal estate tax purposes) of all of the stock of such corporation which is included in determining the value of the decedent's gross estate exceeds 35 percent of the excess of (i) the value of the gross estate of such decedent, over (ii) the sum of the amounts allowable as a deduction under §§ 2053 or 2054. Section 303(b)(2).

Section 303(a) applies to a distribution by a corporation only to the extent that the interest of the shareholder is reduced directly (or through a binding obligation to contribute) by any payment of an amount described in paragraph (1) or (2) of § 303(a) of the Code. Section 303(b)(3).

If a corporation distributes amounts in a redemption to which §§ 302(a) or 303 applies, the part of such distribution which is properly chargeable to earnings and profits

shall be an amount which is not in excess of the ratable share of the earnings and profits of such corporation accumulated after February 28, 1913, attributable to the stock so redeemed. Section 312(n)(7).

### Conclusion

Based solely on the representations made and the information submitted, we conclude that X's S election terminated on Date 3, under § 1362(d)(3)(A), because X had accumulated earnings and profits at the close of each of three consecutive tax years beginning Year 1, and had gross receipts for each of those years more than 25% of which were passive investment income.

We further conclude that the termination of X's S election was an inadvertent termination within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from Date 3 through Year 4 and thereafter, unless X's S election is otherwise terminated under § 1362(d). This ruling is conditioned on X sending a payment of \$n with a copy of this letter to the following address: Internal Revenue Service, Cincinnati Service Center, M/S 343G, Cincinnati, OH 45999. If this condition is not met, then this ruling is null and void. Furthermore, if this condition is not met, X must send notification that its S election has terminated to the service center with which X's S election was filed.

Additionally, the part of the distribution in redemption of X's stock which is properly chargeable to earnings and profits shall be an amount which is not in excess of the ratable share of the earnings and profits of the Corporation accumulated after February 28, 1913, attributable to the Corporation's stock redeemed (u%). Section 312(n)(7).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of this transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether X's S corporation was valid under § 1362.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

*David R. Haglund*

David R. Haglund  
Senior Technician Reviewer, Branch 1  
Office of Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures

A copy of this letter

A copy for § 6110 purposes